



JENNIFER M. GRANHOLM  
GOVERNOR

STATE OF MICHIGAN  
OFFICE OF THE STATE BUDGET  
LANSING

ROBERT L. EMERSON  
DIRECTOR

March 30, 2007

The Honorable Jennifer M. Granholm, Governor  
Members of the Legislature  
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2006.

### **INTRODUCTION TO THE REPORT**

**Responsibility:** The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

**Adherence to Generally Accepted Accounting Principles:** As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

**Report:** The SOMCAFR is divided into three major sections: introductory, financial, and statistical:

- The introductory section includes this letter, the State's organization chart, and the list of principal officials.
- The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provide an introduction, overview, and analysis to the Basic Financial Statements; the Basic Financial Statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with footnotes to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules.
- The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

**Internal Control Structure:** The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. The system of internal control has been designed to provide reasonable rather than absolute assurance that the financial statements are free from material misstatement.

All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, Attorney Discipline System, the State Employees' Deferred Compensation Funds, the State Employees' Defined Contribution Retirement Fund, and the Michigan Education Savings Program. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies.

The Management and Budget Act requires each principal department to appoint an internal auditor and to maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time

schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

Independent Auditors: The Office of the Auditor General (OAG) is the principal auditor of the SOMCAFR. The OAG also relies on the opinions of outside public accounting firms, particularly for component unit financial statements (such as the Michigan State Housing Development Authority and 10 of the State's universities), the larger pension and other employee benefit trust funds, and the Unemployment Compensation funds. The purpose of the OAG's audit is to provide reasonable assurance that the Basic Financial Statements for the fiscal year ended September 30, 2006 are free of material misstatements. The OAG concluded that the Basic Financial Statements for the fiscal year ended September 30, 2006 are fairly presented in accordance with GAAP and issued unqualified opinions.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial statement and performance audits of the various State departments, agencies, and institutions of higher education. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies and component unit authorities, and result in separately issued audit reports.

Management's Discussion and Analysis (MD&A): GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

## **PROFILE OF THE GOVERNMENT**

Michigan was admitted to the Union as the 26<sup>th</sup> state in 1837. The State is governed under the Constitution of 1963, as amended.

Executive Branch: The Executive Branch consists of 19 principal departments. Sixteen principal departments are headed by commissions and/or directors appointed by the elected governor. Elected officials head two principal departments, Attorney General and State, and one, Education, is headed by an elected board.

Judicial Branch: The Judicial Branch consists of the Supreme Court, Court of Appeals, Court of Claims, and the State's circuit, district, probate, and municipal courts. In addition to its judicial duties, the Supreme Court is responsible for the general administrative supervision of all courts in the State. The Supreme Court also establishes rules for practice and procedure in all courts.

Legislative Branch: The Legislative Branch consists of the Senate, House of Representatives, and Office of the Auditor General. The Senate, which consists of 38 elected members, and House of Representatives, which consists of 110 elected members, enact the laws of Michigan. The Office of the Auditor General conducts post financial and performance audits of state government operations.

Reporting Entity: The financial reporting entity of the State includes all of the funds of the primary government as well as component units for which the State's elected officials are financially accountable. The transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

Budgetary Reporting and Control: For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), the State budgets projected revenues and expenditures and calculates fund balance for budgetary purposes in accordance with GAAP. Public Act 431 of 1984, as amended, prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR. In addition, subsequent to the publication of the SOMCAFR, the State releases a Statewide Authorization Dispositions report that provides line item appropriation details, the legal level of budgetary control, for the General Fund and budgeted operating funds.

## **ECONOMIC CONDITIONS AND OUTLOOK**

U.S. Economy: The current U.S. economic expansion is now five years old, having begun in November 2001. The U.S. economy, as measured by inflation-adjusted gross domestic product, is estimated to have grown 3.3% in 2006 and is predicted to slow substantially to 2.2% in 2007 before rebounding to 2.7% growth in 2008.

Light vehicle sales fell 450,000 units to 16.5 million units, the lowest level since 1998. The Big Three vehicle market share continued to shrink. As a result, Big Three vehicle sales fell from 9.7 million units to 8.9 million units, the lowest level since 1992. Light vehicle sales are forecast to be 16.3 million units in 2007 and 16.5 million units in 2008.

U.S. employment has increased each month since mid-2003. Employment gains in 2006 averaged approximately 190,000 jobs a month. Monthly U.S. employment now exceeds its pre-recession peak by 4.6 million jobs. For calendar year 2006, U.S. employment rose 1.8%. The U.S. unemployment rate is projected to remain relatively stable with a 4.6% and 4.7% unemployment rate in 2007 and 2008, respectively.

**Michigan Economy:** Michigan's economy relies heavily on the performance of the manufacturing sector in general and the auto industry specifically. Given extremely weak manufacturing employment performance, declining vehicle production, continued declines in Big 3 market share along with continued supply rationalization among vehicle suppliers, Michigan employment performance has been below the national average. Substantial productivity gains in the vehicle industry have also contributed to Michigan's sub-par employment performance.

Michigan personal income is forecast to increase 2.8% in 2007 and 3.0% in 2008. In fiscal year 2007, wages and salaries are expected to grow by 1.5% and then slow to 1.2% growth in fiscal year 2008. The inflation rate is expected to remain moderate at 1.3% in fiscal year 2007 and 2.5% in fiscal year 2008.

## **MAJOR INITIATIVES AND FUTURE PROJECTS**

**Jobs and Economy:** Strong business and entrepreneurial investment, a skilled and dedicated workforce, and effective infrastructure and transportation systems fuel Michigan's economic engine. During fiscal year 2006, the State created the 21<sup>st</sup> Century Jobs Fund and provided \$400 million to invest in areas such as life science technology, advanced automotive, manufacturing and materials technology and alternative energy technology. Over the next decade, the State will invest \$2 billion in public and private resources to diversify the economy and create jobs.

State government is also committed to investing in its workforce. The Michigan Opportunity Partnership, created to fast-track jobs in high demand areas such as health care and the building trades, is aimed at matching and placing qualified resources in new jobs. In addition, beginning in 2006 and continuing in 2007, the departments of Human Services and Labor and Economic Growth are collaborating on a new Jobs, Employment and Training (JET) pilot to provide intensive services to long-term cash recipients in order to reduce poverty and welfare dependency, which is expected to save \$11 million in 2007.

The effective and efficient movement of people and goods is critical to growing Michigan's economy. Continued investment in road infrastructure projects is necessary to keep pace with the accelerated demands of modern commerce. Over \$3.4 billion, or 8.1%, of the State's total fiscal year 2007 budget is dedicated to transportation programs such as new construction and maintenance for local road and bridge projects, airport infrastructure improvements, and public transportation programs.

**Education:** The State is committed to providing a quality education to all age levels. Over \$15.3 billion, or 36.1%, of the State's total fiscal year 2007 budget is devoted to educating Michigan citizens through its public schools, community colleges and universities.

The School Aid Budget, totaling \$13.1 billion, reflects the commitment to provide all students in the K-12 educational system with the tools they need to succeed in a global economy. During fiscal year 2007, the minimum foundation allowance was increased to \$7,100 per pupil, the highest amount in the state's history. In addition, a new after school program for middle school pupils was created to focus on math, science and computer technology and help students meet local, state and federal standards and better prepare students for more rigorous high school curriculum expectations.

In order to compete in a global economy, Michigan must significantly increase the number of citizens who attend and complete post-secondary education programs. To support this goal, state colleges and universities will receive \$2.1 billion during fiscal year 2007.

**Health and Human Services:** For fiscal year 2007, the two departments primarily responsible for health and human services, the Department of Community Health and Department of Human Services, account for \$15.7 billion, or 36.9%, of the overall State budget.

While the State administers a variety of health and human services programs, Medicaid is the most extensive, accounting for \$8.6 billion of the fiscal year 2007 budget. This program provides a social safety net for low-income families and vulnerable adults, by providing coverage to over 1.5 million people, of which nearly 900,000 are children. The program ensures that low-income families, the elderly, and the disabled receive high-quality, cost effective health care, while reducing the burden of uncompensated care costs on providers.

During 2006, the State announced the Michigan First Healthcare Plan, with the overall goal of making quality health care accessible to all Michigan residents. By partnering with insurers, the business community, and health care providers, the plan will create a competitive market-based health insurance exchange to expand access to more than 500,000 low-income parents and adults. The state anticipates receiving federal approval for this program this spring.

Hometown Security: Protection of Michigan's residents is a top priority and a core function of state government, accounting for \$2.9 billion, or 6.8%, of the overall State budget in fiscal year 2007. Hometown security requires a balanced spectrum of state activities from street-level public safety programs, to military preparedness of the Michigan National Guard, to the incarceration of dangerous felons. The departments of Corrections, Judiciary, Military and Veterans Affairs, and State Police are charged with providing protection services to our citizens.

Environment: State government is committed to the conservation, protection, management, use, and enjoyment of the State's natural resources for current and future generations. Michigan has 11,000 inland lakes, 36,000 miles of rivers and streams, and 3,000 miles of freshwater shoreline. Numerous park and recreation areas enable Michigan's citizens and visitors to enjoy outdoor recreation in a fun and safe environment on public lands and waters while benefiting the economy. Michigan lands also yield several agricultural products which rank number one nationally in the State's second largest industry – agricultural production.

Efforts to enhance the quality of Michigan's natural environment are primarily the responsibilities of the departments of Agriculture, Environmental Quality and Natural Resources who will spend approximately \$845.7 million in fiscal year 2007.

Better Government: Making government more cost effective and efficient is a primary focus of state government. Better government in Michigan means keeping the budget balanced, providing fast and friendly service to all citizens, cutting red tape, and frugally managing the workplaces, tools, and equipment of state government. It also means improving collaboration in order to increase efficiencies, improving services through the use of technology, making Michigan more equitable for all residents, and making state government a great place to work.

The State is continuing with a number of technology initiatives in fiscal year 2007 that will result in streamlining and consolidating computer operations and equipment. For example, the Human Resources Call Center, created in the Department of Civil Service, streamlines human resource operations and is estimated to save \$25 million by 2009. In addition, the Department of Human Services continues to develop an integrated human services delivery system to improve services to citizens in need.

State government agencies, local units of governments and school districts are exploring efforts to consolidate and share resources to keep spending in check. Consolidating business services, administrative personnel and other like services will help cut waste and create efficiencies across state government.

#### **AWARDS AND ACKNOWLEDGEMENTS**

Certificate of Achievement: The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2005. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report whose content satisfies both generally accepted accounting principles and applicable legal requirements.

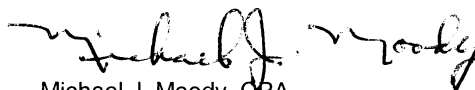
A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for 19 consecutive years. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgments: The preparation of this report requires the collective efforts of the management and staff of the Accounting and Financial Reporting Division, Office of Financial Management; the chief financial officers, chief accountants, internal auditors and their staffs from all State agencies; and the management and staff of the Office of the Auditor General. We sincerely appreciate the dedicated efforts of all of these individuals that have allowed Michigan to maintain its position as a national leader in quality and efficiency for financial reporting.

Sincerely,



Robert L. Emerson  
State Budget Director



Michael J. Moody, CPA  
Director, Office of Financial Management